THE THEORY OF RAILROAD REORGANIZATION

With the advent of the government administration of the railroads the long period of American railway building may be said to have closed. Since 1907 the amount of new construction has steadily declined, and since the opening of the Great War has been relatively less than at any time since the panic of 1873 and absolutely less than any year since 1895, so that the construction of our main railroad net had well nigh reached our economic demands a number of years before the operation of the roads passed out of private control. During this long period of nearly ninety years an institution absolutely essential to our present economic and social life has been started, nurtured through its infancy of mistakes and miscalculations, brought to a state of standardization, and finally extended into every corner of the country. As a whole, the construction of this system of transportation has progressed steadily, and in remarkably close parallelism to our economic needs. At times the progress has been temporarily interrupted by panics or temporarily stimulated by industrial booms, but in general the building of our transportation system has been systematic, well ordered, and remarkably economical of capital and natural resources. When there has been an hiatus between economic demand and railroad construction, the difficulty has arisen far oftener because of the building of a railroad before it was needed than because of the existence of an economic demand before there was a railroad to meet it. Considering all these things, therefore, the economic historian in some far future time would probably speak of this ninety-odd years as the epoch of railway construction. We do not know what policies toward the railroads will be evolved in the period following the Great War, but we do know with certainty that this first long period has developed a body of precedents, conventions, and public policies, the origins and the present forms of which we can trace with accuracy.

The present series of articles discusses one of these sets of conventions—that dealing with the financial reorganization of our American railroads. It is the analysis of the expedients—evolved through necessity—that we have applied to reëstablish the financial solvency of a bankrupt railway corporation. It is at once the most intricate and in a very true sense the most fascinating aspect of railroad finance. Historically it was the last topic to settle down into clearly defined and fairly comprehensive lines of general policy.

The expedients and conventions of contemporary reorganization practice have grown up in direct response to the needs of a rapidly building railway system, not always balanced and not always financially sound in its parts. Moreover, like the railway net itself, the present practices concerning financial reorganization pertain to the period of construction and development, the period of the gradual dawn upon our intelligence of the importance of railway transportation, with the accompanying pangs of our political and social consciousness to adjust themselves to the rapidly changing economic organization that this importance demanded. It has been essentially an American problem. Our financiers have had no historical or transatlantic precedents to guide them. Notwithstanding this, the development of the theory and practice of railroad reorganization is one of the most original and noteworthy achievements of American business genius.[1]

This present article is concerned with the general problem of railroad reorganization and its historical aspects. The second will give an outline of reorganization procedure as now worked out by the courts and reorganization committees. The third article will discuss reorganization plans and the ends achieved in current reorganization practice.

The primary source of material covering railroad reorganization is confined to the circulars, reports, and plans published by the various committees preceding and during the actual reorganizations. These are not ordinarily accessible in themselves, but comprehensive summaries are printed in the *Commercial and Financial Chronicle.* The secondary sources are surprisingly meager, considering the importance of the subject. There is but one comprehensive study[2] and five or six short periodical articles.[3] Most of these, however, were written before the last group of railway reorganizations established a kind of definitive form for contemporary reorganization policy.

1 It was well said, more than fifteen years ago, that "The reorganization of American railways is a more noteworthy achievement than the payment of the French indemnity or the refunding of the United States debt. It is noteworthy not merely in the amount of securities involved, but on account of the excellence of the principles which have guided its managers in their action." E. S. Meade, *The Reorganization of Railroads,* Annals Am. Acad. Pol. & Soc. Sci., vol. 17 (1901), p. 242.

2 S. Daggett, *Railroad Reorganization,* Harvard Economic Studies, vol. IV.

3 Comprehensive bibliography of essays and periodical articles pertaining to railroad failures, receiverships, and reorganizations is given in Cleveland and Powell, *Railroad Finance* (1912), pp. 364-7, 369.

Most of the early railroad receiverships[4] and all those after 1890 were the direct result of actual or threatened insolvency, using the term insolvency to imply an inability to meet maturing liabilities. These maturing liabilities were of three kinds—the principal of a funded debt (rarely a cause of failure), interest on funded debt, and current debts for materials and labor. The immediate cause of financial embarrassment in the vast majority of the earlier cases was the inability to meet maturing interest on the funded debt; the immediate cause, of late, has been more frequently the acknowledged inability to meet current expenditures for materials. In either case, the weakened credit was only the outward sign of diminished earning power, and this, in its turn, merely the evidence of a deep-seated and fundamental weakness.

The fundamental weakness, the primal cause of the vast majority of railway failures, ever since the first crop following the panic of 1837, has been over-extension. In the earlier days of railroad building, this was extension into well developed territory without measuring the costs of construction; during the third quarter of the last century it was extension into territory insufficiently developed, economically, to maintain a railroad.[5] Subsequently, failure has resulted from the over-building of branch line feeders in the hope of "creating" new traffic. Of late years railroads have suffered from the weakness incident to mere size, such as combination and consolidation of financially and economically weak railway systems, the absorption of one system by another, of one group of railways by another group, or even (as has been true many times) the embarkation of the railroad in other remotely connected industries. With the over-expansion, the business as a whole earned a steadily declining rate of return on the average unit of investment. It became thinner, through a rather rigid application to the railroad industry of a kind of diminishing return on capital investment. As large amounts of money are required to meet the costs, over-expansion of a railroad, in whichever direction it occurs, has been accompanied, inevitably, by an increase in the funded debt, both relatively to the total invested capital and absolutely per mile of railroad. Two tendencies, therefore, operated at the same time, a decrease in earnings and an increase in charges on the funded debt. Ulti-

[4] List of exceptions cited in H. H. Swain, *Economic Aspects of Railroad Receiverships,* Economic Studies, vol. III (Am. Econ. Assoc., 1898).

[5] This is true of practically all the railroad failures occasioned by the panics of 1873 and 1884.

mately, when the interest charges exceeded the earnings, the company failed. But this failure was invariably postponed by the operation of palliatives; first the charges for maintenance were cut to the marrow and a large floating debt was piled up.

In view of these generalizations, surprisingly free from exceptions, considering the variety of origin, location, and administration of our railroads, it is possible to observe that every railroad reorganization must penetrate beneath the tangle of proximate causes and either lop off the parasitic wastes resulting from overexpansion or else so remould the financial plan of the railroad that the interest charges shall be less, not greater, than the net earnings. Sometimes a reduction in mileage is effected as a part of the plan of reorganization; but as the railroad management invariably ascribes the failure to superficial rather than ultimate causes the other alternative, that of recasting the financial plan so that the fixed interest charges may lie well within the earnings, is the underlying motive of every reorganization. About this, every other feature of the reorganization turns. It is felt by all concerned that failure was due to maladjustments resulting from rapid expansion, and not to the expansion itself. If, therefore, the road is permitted relief from its overpowering burden of fixed charges, it will recover its poise. Railway pioneers in earlier days, and railway expansionists in the last epoch, have been constitutionally optimists; they prescribed merely a rest for their patient, not surgery. The history of railroad reorganization practice, as we shall see presently, has been the history of a gradual realization that the rest, to be permanently curative, must be accompanied by surgery.

Reduction in fixed charges was, therefore, the primary purpose of every railroad reorganization, but it was not the only purpose. It has been stated already that a railroad on the verge of bankruptcy can postpone the acknowledgment of its failure by two means—a reduction in the expenses necessary to maintain the physical integrity of the road, and an increase in the amount of its floating debt. Both means are usually resorted to. Consequently, when failure is finally admitted through the appointment of a receiver, the court finds the road very much out of repair because of insufficient maintenance expenditures and heavily burdened by an incubus of floating debt. Formerly the rehabilitation of the road and the liquidation of the floating debt were allowed to wait until the period of reorganization, but of recent years

courts have permitted receivers to borrow money on their own certificates for these purposes. In any event, however, the plan of reorganization must provide sufficient money either to rehabilitate the road and pay its pre-receivership debts directly or else to pay the receivers' certificates which had been sold for the purpose of accomplishing these ends during the receivership. Ample new money, then, under any circumstances, is the second essential purpose of every railroad reorganization. And since the credit of the bankrupt property is low, both because of its previous history and the notoriety given to it by the fact of a receivership, outside investors will not buy its securities. The new money must be exacted from the old stockholders as the only persons sufficiently interested in the property to make sacrifices to help it in its hour of need.

While these two purposes, a reduction in fixed charges and the collection of new money from old security holders, have been the paramount issues in every railroad reorganization, they have not been accomplished by the same means. This is what makes the definition of railroad reorganization difficult if one stresses the means employed, rather than the ends achieved.[6] On the other hand, since the ends to be achieved are so strikingly uniform, we can define a railroad reorganization as *a comprehensive change of the financial plan, necessitated by impending or actual failure, such that the fixed charges are reduced and new money is supplied through the sacrifices of security holders.*

The means for accomplishing these ends have undergone radical changes and it is in the light of the historical aspects of the subject that the present theory and practice of railroad reorganization are best understood. Historically, the practices pursued in dealing with a bankrupt railway may be divided arbitrarily, yet with considerable definiteness, into various periods separated from each other by the successive panics. In actual experience the panic years have served as nodal points in the developments of railway finance. Weak railroads have failed in great numbers

[6] Two definitions that are inadequate for this reason are: "The reorganization of a bankrupt railroad is a settlement of the claims of the different parties in interest on such a basis that the property can be released by the court and again managed as a going concern." Meade, *Ann. Am. Acad.*, vol. 17, p. 205. "The term reorganization is used in this study to denote the exchange of new securities for the principal of outstanding, unmatured, general mortgage bonds, or for at least 50 per cent of the unmatured junior mortgages of any company, or for the whole of the capital stock." S. Daggett, *Railroad Reorganization* (1908), p. 335.

at those times,[7] and because of the greater number of decrepit railroads requiring help, these periods have witnessed the most fundamental and conspicuous changes in reorganization practice.

The first period comprises all the attempts to rehabilitate the earlier, distinctly local railroads. It extends down to the railway failures following the panic of 1857. Railroads were not reorganized in anything like the modern sense; they were merely "set a-going again"; there was no settled and established policy; the failure of each road being treated as an essentially local and individual problem. The second period extends from 1860 to the years succeeding the railroad panic of 1884. It is characterized by several relatively large reorganizations; indeed it may be said to be separated from the earlier period by the fact that in 1861 and 1862 two of the largest railroad systems had to be reorganized in more than merely local terms.[8] A more closely defined policy was necessary. Railroad reorganization, during this period,

[7] Elaborate statistical tables by J. P. Meany (*Poor's Manual of Railroads, 1900,* 33d Annual Number, pp. lxii and cxiii), giving statistics from 1884 to 1899; and H. H. Swain (*Econ. Aspects,* etc., p. 68), giving statistics from 1870 to 1897. The two compilations are by no means identical, but the discrepancies, in terms of the percentage of the country's railroad mileage, are relatively small. Summaries, also, from time to time in the railway journals (*Railway Age Gazette,* vol. LII, p. 945 and vol. LVI, p. 4). Crowell gives certain summaries for the period surrounding the panic of 1873 (*Yale Review,* vol. 7, 1898, p. 319) but does not give sources of his figures. A summary statement is given also in the *Commercial and Financial Chronicle* at the time (vol. 17, p. 647; vol 22, p. 75). Many rough estimates have crept into use without a statement of their origin. Ripley has made a short summary of railroad failures, drawing his figures largely from the computations of Swain and has prepared an extremely enlightening diagram (W. Z. Ripley, *Railroads,* vol. II, p. 374 and following).

Some railway systems have been prolific in failures. Thus, omitting smaller lines of local significance, seven railway systems of national significance have failed and been reorganized three times: the Erie (1861, 1878, 1895); the Philadelphia and Reading (1883, 1888, 1896); the old New England Railroad (1871, 1885, 1895); Toledo, St. Louis and Western (1886, 1899, and now in 1918 awaiting treatment); Wabash (1877, 1888, 1915); St. Louis and San Francisco (1876, 1896, 1916); Missouri, Kansas and Texas (1876, 1891, and now in 1918 awaiting treatment).

Likewise some managements are conspicuously prolific in failures. Of the various component parts of George Gould's prospective transcontinental railway system all have failed at least once since the blight of Gould management touched them. Those, like the Wabash and Iron Mountain roads, which have been under this management longest have failed the greater number of times.

[8] Pittsburgh, Fort Wayne and Chicago in 1861, and the old New York and Erie in 1862, both about 470 miles in length.

ceased to be a matter of merely local interest, and there dawned upon the law and public consciousness the fact that a bankrupt railroad was not to be treated as a private bankrupt estate. The third period extends from 1884 to the panic of 1893. The principles of railroad reorganization as now recognized were being worked out in tentative form during this time. Railroad reorganizations had become matters of public moment. The courts had come to realize fully the public service character of railroad corporations, and the receivership and reorganization were supervised in accordance with principles then being developed in an indirect and cumbersome manner. The fourth period extends from 1893 to 1908. It includes the great railway reorganizations succeeding the receiverships due to the panic of 1893 and the following depression. The principles which were vaguely developed in the preceding period were applied to the rehabilitation of some of the greatest railway systems of the country. The fifth period comprises the latest reorganizations, especially those succeeding the railway failure of 1913 and 1914. These financial readjustments were clear cut, and remarkably simple considering the large mileage of the systems involved and the intricacies of the financial structures. The fact that these recent railroad reorganizations have been consummated so quickly, so easily, and with so little friction, is an indication that the practice of railroad reorganizations has passed its formative periods and has become crystallized along well defined lines.

In a detailed discussion of the five periods outlined above, little need be said of the first. There were many railroad failures during the thirty years from 1830 to 1857, but they were quite as much the failures of promoters as the failures of their railroads. A projected railroad underestimated its cost. The subscribed capital was insufficient to finish it, and the promoters were forced to sell more stock or more debenture bonds. In the sense of an extension beyond the available means, these early failures were analogous to those of the later periods, and in the accumulation of a heavy floating debt they were characteristic of their modern counterparts. But there was no recognition on the part of the promoters of a defective financial structure, no conscious intention to remodel the financial plan of the little railroad in accordance with its earnings. Then, too, capital stock predominated in

the financial structure,[9] and mortgage bonds having the theoretical right of foreclosure were not issued until the late forties.[10]

When the building of the partially completed road came to a standstill for lack of funds, then the promoter, the local merchants and squires, the towns and counties, or other equally restricted groups, merely bought more stocks and debenture bonds in order to complete the line. Such financial adjustments, even those following the panic of 1837 and the depression extending until 1846, were in no sense reorganizations of financial structure. They were integral parts of the practical working-out of railway promotion, episodes in the stupendous and all absorbing task of substituting steam rail transportation for older and cruder means.

But with the railway failures consequent upon the panic of 1857, a new problem arose. Fully built railroads failed for other reasons than mere unfinished construction. Several of these failures stand out clearly as analogous to the more recent failures of railway systems from the point of view of their size and the economic development of rail transportation.[11] We can therefore

[9] As late as 1855, after over 17,000 miles of line had been built, the gross funded debt amounted to slightly less than \$300,000,000, whereas the share capital amounted to \$425,000,000. On this capitalization the railroads were then operating on a 50 per cent ratio, and the net earnings for the year 1855 amounted to over \$40,000,000. This was over 12½ per cent on the funded debt. In New England and the southern states, where were located approximately half the mileage—consisting of small locally owned railroads—the net earnings were over \$13,000,000, whereas the funded debt was only \$72,000,000—earnings of nearly 20 per cent. From this it is apparent that, once built, the railroads were able to meet their fixed charges, so that the later problem of reorganization, as the problem of reducing fixed charges, was not then paramount.

[10] The earliest record I can find of a railroad mortgage bond, in the modern sense, was that of the Madison and Indianapolis Railroad in 1848. Historically the first idea of a railroad mortgage was the New York statute of 1834 enabling the old Mohawk and Hudson Railroad Company (New York's first railway chartered in 1826) to issue a mortgage of \$250,000 to carry on construction. In 1846 the Baltimore and Ohio issued bonds with a lien on the physical property, and in 1847 the original New York and Erie Railroad its old first mortgage bonds. (These are still outstanding, having been extended to 1947.) But these are not analogous to the modern form, being merely mortgages to specifically secure state loans, and were without covenants.

At the time of the panic of 1857, mortgage bonds were practically absent from the financial plans of New England and southern railroads. They were comparatively rare among the roads of the middle states, and the exception, rather than the rule, among the roads then built in the western states.

[11] The Marietta and Cincinnati, 180 miles, failed in 1858 and reorganized in

look upon the reorganizations following the panic of 1857 as initiating a new era of railroad reorganization finance.[12]

Characteristic of the mental attitude of the men who guided railway finance at the beginning of this period was the reorganization of the two most important railway failures of the time, the New York and Erie Railroad, the original stem of the present Erie system, and the Pittsburgh, Fort Wayne and Chicago, the western line of the Pennsylvania system.

The old New York and Erie Railroad[13] had been completed in 1851, but had never become prosperous. It suffered severely during the panic of 1857. Low maintenance charges had increased enormously the mere cost of operation, and these difficulties were aggravated by floods and line washouts; the road had suffered from a strike of its engineers, who antagonized the public against the road by reporting that "only boys" were running the trains. Its terminal in Jersey City was unfinished. Its treasurer, the notorious Daniel Drew, had been running competitive steamship lines and otherwise administering the road's treasury to his personal advantage. On the financial side the picture was even more disheartening. Unpaid judgments for over $700,000 were outstanding against the company; it had accumulated a floating and unsecured debt of over $8,000,000, and the old second mortgage of $4,000,000 had matured and remained unpaid. The road had

1860; the St. Louis, Alton and Chicago Railroad, 225 miles, failed in 1859 and reorganized in 1862; the New Albany and Salem Railroad, 292 miles, failed in 1859 and reorganized in 1862; the Great Western Railroad, 170 miles, failed in 1859 and reorganized in 1862; the New York and Erie Railroad, 447 miles, failed in 1859 and reorganized in 1862; the Pittsburgh, Fort Wayne, Chicago Railroad, a consolidation formed in 1856 of three railroads, completed as a line to Chicago in 1858, failed in 1860 and reorganized in 1862. These last two roads were then of great importance.

[12] One of the interesting developments of the time was that the courts began to look upon railway receivers as administrators and managers of railway property, not merely trustees for the settlement and liquidation of private contractual obligations. For example, the courts began to tolerate constructive efforts on the part of their receivers; thus the receiver of the Columbia, Piqua and Indiana Railway was allowed, in 1858, to build some thirty-five miles of road (*American Railroad Journal*, vol. 16, p. 555; Cleveland and Powell, *Railroad Finance* (1912), p. 240, cite other later instances. The practice was not universally acknowledged, however, until the Baltimore and Ohio Railroad receivership (1896) when the court permitted its receivers to do everything private managers might do.

[13] Because of the fact that later reorganizations of the Erie can be used for comparison, the first reorganization of the New York and Erie Railroad only will be used for illustrative purposes.

defaulted on the interest on all its other bonds, even the interest on the old underlying first mortgage bonds. And capping all these difficulties, the road was earning actually less than its mere operating expenses. The president of the road made a hurried trip to England in the hope of inducing the British security holders to come to the rescue, but the effort was futile. Finally, in its last extremity, receivers were appointed in August, 1859.

At the time of its failure, the affairs of no great railroad system, reorganized after 1893, were in such despicable condition as those of the old New York and Erie in 1859. It had a notorious celebrity—in financial districts and in the public press.[14] One would presume, therefore, that the reorganization consummated under these disheartening conditions would be as drastic and comprehensive as the generally acknowledged reorganization policy of the period would countenance. Yet there was nothing either drastic or comprehensive about the reorganization finally consummated in 1862. The mortgage bondholders were required to make no sacrifices whatever, the small assessment of only 2 ½ per cent levied on the stockholders being used to meet their overdue coupons. The large floating debt was funded into preferred stock. On the whole, the position of the common stockholders was distinctly stronger, in so far as the menace of a floating debt nearly as large as the common stock[15] had been permanently funded into a type of security having merely a contingent lien on earnings. Although probably the most disheartening failure, all things considered, of a prominent railroad, its reorganization is almost unique in the small amount of sacrifice demanded from any of the security holders.

In 1875 the Erie Railway failed again, after the panic of 1873. Again it was one of the most severe and far-reaching failures of the time. And again the individual conditions surrounding the failure were almost as disheartening as those of 1859. Nevertheless the reorganization of 1878 was consummated on the basis of funding into 7 per cent bonds overdue coupons on certain junior issues of bonds[16] and making a small assessment on the stocks.[17]

[14] All the mortgage bonds, even the old first mortgage bonds of 1847, were quoted at merely nominal figures, and the stock was difficult to sell at two or three dollars a share.

[15] Prior to the reorganization the floating unsecured debt amounted to $8,500,000 and the common stock to $11,000,000.

[16] The funding of coupons into bonds of the same general tenor was a frequently used method of securing temporary relief from a pressing burden of fixed charges, during the reorganizations of the middle and late seventies

The significant change from the preceding reorganization was the funding, for a short time, of alternate coupons on certain junior bonds. This, to a very limited extent temporarily reduced fixed charges, whereas in the earlier reorganization no effort was made to effect even a temporary reduction in fixed charges. In other words, although both failures were severe, neither reorganization demanded any sacrifice from the security holders at all consonant with the severity of the failure, and the only significant difference between the two reorganizations was that in the one following the panic of 1857 neither a temporary nor permanent reduction in fixed charges was accomplished, whereas in that following the panic of 1873 there was achieved a small temporary but no permanent lessening of the fixed charges.[18] And this was the general temper of all the important reorganizations following the panic of 1873. As one keen observer remarked, "the railroads which failed in the early seventies were not really reorganized—they were simply regalvanized."[19]

The railroad panic of 1884 initiated numerous failures. There were many half finished railroads, the failure of which was like that of the early railways of the Eastern Atlantic states following the panic of 1857;[20] there were other competitive railroads

and early eighties. It was, for illustration, a prominent feature of the reorganization of the St. Louis, Iron Mountain and Southern in 1878.

17 Four per cent on the common and 2 per cent on the preferred. But the shareholders could pay, if they preferred, half again as much (6 per cent on the common and 3 per cent on the preferred) and receive income bonds for the assessment. Most of the shareholders elected to pay the smaller payments.

18 Details covering the failure and reorganization of the New York and Erie are best obtained from E. H. Mott, *The Story of the Erie,* page 123 and following; S. Daggett, *Railroad Reorganization,* page 35, gives a short epitome, but the account is inadequate to the historical importance of the episode. The details of the second failure and reorganization are best obtained from Mott and the fuller account in Daggett, pages 37-50. Also see *Commercial and Financial Chronicle,* vol. 21 (1875), p. 612; vol. 28 (1879), p. 67; vol. 29 (1879), p. 358; and Hepburn Committee Report, vol. 2, p. 252.

19 J. F. Crowell, "Railway Receiverships in the United States," *Yale Review,* vol. 7 (1898), p. 326.

20 Types of such failures were the first failure of the Atchison, Topeka and Santa Fe Railway, consequent upon its growth from 2,800 miles in 1884 with net earnings of over $7,000,000, to over 7,000 miles in 1888 with net earnings of less than $7,000,000. Of lesser moment, yet of the same character in being failures of unfinished poorly constructed, half developed railway systems, located in different parts of the country, were the Denver and Rio Grande Railroad, failed in 1884, reorganized in 1885; the Florida Railway and Navigation Company, failed in 1885, reorganized in 1888; the Houston and

which were built, in fully developed territory, for the single and often avowed purpose of being bought out by stronger rivals, but which were too weak even to initiate the struggle, much less carry it to a successful issue.[21] But fully characteristic of the reorganization policy of the period, as it showed itself in the reorganization of a fully developed and completely articulated railway, was that of the Wabash, St. Louis and Pacific Railway,[22] the antecedent of the present Wabash Railroad. The road failed May, 1884; it was the first of our great American railway systems to throw itself into the hands of receivers.[23] The fundamental reason for this failure was over-extension of branch lines.[24] It embraced

Texas Central Railway, and the Houston East and West Texas, both failures in 1885 and reorganized, the former in 1888 and the latter in 1892 (both now important parts of the Southern Pacific's Texas lines.)

21 Two of these buccaneering enterprises did much to bring about and make serious the railroad panic of 1884. The old New York, West Shore and Buffalo was built along the west bank of the Hudson River for no other purpose than to create a "nuisance value" to the Hudson River Railroad. It failed in 1884, with only 475 miles of line but the enormous capitalization of $40,000,000 of stock and $70,000,000 of bonds. It was reorganized the following year at great sacrifice to the security holders, very unusual for the period. (The first mortgage bondholders were forced to accept 50 per cent in new bonds). The New York, Chicago and St. Louis Railway was built in the early eighties to parallel the Lake Shore and Michigan Southern Railway. It failed in 1885 and was reorganized in 1887.

22 The history of this road is illuminating and typical of the growth of our American railway systems. It was formed in 1879 as the consolidation of the old Wabash Railway and the St. Louis, Kansas City and Northern Railway. The former, the old original Wabash Railway, was organized in 1877 out of the Toledo, Wabash and Western Railway. This latter represented a consolidation, in 1865, of the Great Western Railroad, the Toledo and Wabash Railroad, the Quincy and Toledo and the Illinois and Southern Iowa Railways. The Great Western was a descendant, after failures and reorganizations, of the original Sangamon and Morgan Railroad which was begun by the state of Illinois in 1838.

The other unit of the Wabash, St. Louis and Pacific, the St. Louis, Kansas City and Northern Railway, was a reorganization of the North Missouri Railroad, an enterprise chartered in 1857 to build a line from St. Louis through the northern sections of Missouri to Coatsville on the Iowa line.

23 The significance of this classic case will be discussed in detail in the second of these articles on reorganization procedure.

24 This was very clearly stated by the editors of the *Commercial and Financial Chronicle* at the time. "The Wabash, St. Louis and Pacific extended its lines very widely in the years 1879 to 1882 by the acquisition of branch and connecting roads, and thereby assumed heavy liabilities. Although the earnings increased largely, the annual liabilities were still far in excess of the net earnings." (46 Chron. Inv. Sup. 2, 139, March, 1888.)

over 2,000 miles of line, about two thirds east and a third west of the Mississippi.[25] For a while, the system was operated in two equal parts and the parts emerged from receivership separately,[26] but the reorganization plan, with its successive modifications, contemplated a single unified system. This was necessary in order that the road might develop from a heterogeneous mass of independent main lines and foolishly and improvidently constructed branch lines. There were outstanding at the time thirteen separate issues of divisional first mortgage bonds, bearing interest averaging nearly 7 per cent,[27] several issues of second, third, and general mortgage bonds bearing 7 per cent interest. In addition there was the large amount of $16,000,000 general 6 per cent bonds and some $6,000,000 of 6 per cent collateral trust bonds. In addition to all this debt there was $27,000,000 of common stock and $23,000,000 preferred stock. The first plan of reorganization[28] contained two radical provisions. It contemplated the exchange of the $22,000,000 of the general and the collateral trust bonds, both bearing 6 per cent fixed interest, into 6 per cent debenture bonds, bearing 6 per cent interest, payable if earned (income bonds). In other words, the road was to be given a temporary "rest," in that a fixed charge of $1,300,000 was changed to a contingent charge. The second radical provision was that the old preferred stockholders were to be assessed 8 per cent a share, the old common stockholders 6 per cent a share (the new income bonds to be given for their assessment), and the old general and collateral trust bonds 2 per cent. In other words, besides having their interest made contingent on earnings, the old junior bondholders were actually assessed. But the reorganization managers were not satisfied with merely a temporary reduction in fixed charges. In a supplementary plan, under the thor-

25 When the Wabash, St. Louis and Pacific Railway failed in 1884 it was then operated by the St. Louis, Iron Mountain and Southern, and the entire system exceeded 3,600 miles. The text above is pertinent to the reorganization of the Wabash, St. Louis and Pacific Railway proper, as the Iron Mountain lease was broken about a month after the receivership, and the leasehold rights on several of the least important western branches were abrogated.

26 The Wabash Western Railway included the 641 miles west of the Mississippi River and 362 miles east—1,004 miles in all—emerged from the receivership March, 1887. The Wabash Railway included 948 miles east, extending from Toledo to East St. Louis and branches, emerged from receivership in May, 1889.

27 Eight issues, 7 per cent; 4 issues 6 per cent; and 2 issues 5 per cent.

28 September 1, 1885. Digest 41 Chron. 30 (1885).

oughly justifiable excuse of effecting a consolidation and coherent structure of the Wabash lines, the reorganization managers forced, through separate foreclosures, the holders of upwards of nine of the old underlying first mortgage bonds, bearing an average of nearly 7 per cent interest,[29] to accept new 5 per cent bonds issued under a blanket first mortgage. And they forced all the holders of the underlying second mortgage bonds, mostly bearing 7 per cent, to accept new 5 per cent bonds issued under a blanket second mortgage.[30] In brief, the great Wabash reorganization, a landmark in the history of reorganization practice, not only collected an assessment on stockholders and junior bondholders and made contingent on earnings the interest on two large issues of junior bonds, but it also solidified into two senior blanket mortgages, bearing a low interest rate, practically all the underlying high interest bearing bonds—a permanent reduction of fixed charges. Of course, in actual percentages of total charges, the reduction of fixed interest was small and the treatment of the junior bondholders in giving them income bonds with a mortgage lien was not in any sense drastic. The point of importance is that in this historically important reorganization of a great railway system in the late eighties there was some permanent as well as temporary reduction in fixed charges and a distinct, although light, sacrifice was required of all the old security holders, including even the senior underlying bondholders.[31]

[29] Two of these issues, the Toledo and Illinois first 7's and the Lake Erie, Wabash and St. Louis first 7's, had been outstanding since 1853.

[30] These second mortgage 5 per cent bonds were further weakened by the fact that foreclosure suit could not be brought until 18 months after default of interest.

[31] It should not be understood that even this leniency toward security holders, shown in the reorganization of the fully articulated Wabash system was exercised in the reorganization of the partly finished or "nuisance value" railroads mentioned in notes 20 and 21. On the contrary a very wholesome scaling of fixed charges was gradually coming into the consciousness of railroad promoters, though it had not yet reached the understanding of operators of completed systems. In the reorganization of the incompleted Northern Pacific, following the panic of 1873, all the bonds were refunded in a preferred stock. The first mortgage bonds in the New York, West Shore and Buffalo reorganization were scaled down 50 per cent. Many instances existed, then as now, in which the bondholders of unfinished or recently promoted railroads were asked to endure drastic sacrifices. This in no wise affects the strength of the generalization, presently to be developed, that the early reorganization policy for completed, going railroads involved little sacrifice on the part of the security holders. On the other hand the general leniency in the reorganization of completed, operating railroads is illustrated

The panic of 1893 was prolific in railway failures. And the failures were chiefly, unlike those of the preceding panics, of completed, well established, and highly organized railway systems. One of the earliest and most conspicuous of these was the failure in the early part of 1894 of the Atchison, Topeka, and Santa Fe Railway. The system embraced over 7,000 miles of line and constituted then, as now, the only single railroad reaching from Chicago to the Pacific coast. It had been reorganized in 1889, after a period of abnormal and fictitious growth, by the refunding of a multitude of small issues of bonds into two blanket issues of bonds, carrying low fixed charges. But in the intervening years the road had increased its mileage by the acquisition of one railroad after another, without regard for financial expediency or even future solvency. Later, when an independent expert had audited the books it was found that there had been an average deficit of over $1,250,000 for the years from 1891 to 1894, notwithstanding the fact that the company had falsified its books so as to represent an ample annual surplus for each year.

The stocks and bonds of the Atchison were largely held in England. Of the bonds there were outstanding $150,000,000 first mortgage 4 per cent bonds and $84,000,000 second mortgage bonds, then carrying 3 per cent interest. The interest charges had not been earned since 1891 according to the independent auditor, and in addition the road had current debts of $11,000,000. But the English bondholders, solicitous of their interests, proposed in an immediate plan of reorganization merely to refund the second mortgage bonds, then carrying 3 per cent fixed inter-

by the two reorganizations of the Philadelphia and Reading of 1882 and 1887. They point even more clearly to the leniency of early railroad reorganizations when one considers that in the fifteen years between 1880 and 1895 the Reading was in the hands of receivers for an aggregate of over ten years. (For details of the Reading reorganizations see the full account in Daggett, *Railroad Reorganization,* chapters III and IV.) In the reorganization of 1882 the only relief afforded the company was the sale of some senior bonds to fund upwards of $12,000,000 of floating debt. No sacrifices of any kind were demanded of stockholders or bondholders, although the year before the receivership the fixed charges on the debt amounted to $7,500,000 and the net earnings—with inadequate maintenance—to only $5,500,000. In fact the fixed charges were absolutely increased by the reorganization from $7,700,000,000 to $11,500,000—a net increase of 50 per cent (Daggett, *Railroad Reorganization,* p. 357). In the reorganizations of 1887, after a receivership of nearly three years, a receivership brought on by fixed charges of over $16,500,000 with net earnings of less than $13,000,000, the remedy adopted was the paying off of the floating debt by the issue of new general mortgage bonds.

est, into income bonds carrying 5 per cent. The second mortgage bondholders were not assessed, and the 5 per cent income bonds offered them were, considering the future as well as the present, quite as valuable as the bonds they surrendered. The stockholders were to be assessed and the proceeds used to pay part of the floating debt and the overdue unpaid coupons on the old bonds. As one writer observes: "The notable part of the scheme was the anxious care of the bondholders to protect themselves."[32] Subsequent realization of the seriousness of the failure made the American financial interests realize that the English bondholders' plan was an ineffectual and selfish palliative.

A new, broad reorganization policy was dawning upon the consciousness of both bankers and investors, which required that a reorganization to be well done must be thoroughly done. And when the final Atchison plan of reorganization was adopted in 1895, it expressed fully this awakening consciousness. The old 4 per cent first mortgage bondholders, having a prior lien to the entire system, were forced to accept 75 per cent of the principal in new 4 per cent bonds—a cutting of both principal and interest by 25 per cent. To make up for the loss, they were given 40 per cent in new 4 per cent income bonds. The second mortgage bondholders were required to surrender their bonds for preferred stock, and to pay an assessment of 4 per cent.[33] In other words, they were forced to accept the position of losing partners in the enterprise, not creditors.[34] This change from the English bondholders' mild and superficial reorganization plan to that finally adopted by the American financiers, was, in a very true sense, a crucial change in the historical evolution of our reorganization policy. The former was a makeshift palliative; the latter was a thorough, comprehensive financial readjustment. And the fact that the former was rejected and the latter accepted indicated that a mere palliative with a minimum of sacrifices and a temporary, not permanent, decrease in fixed charges was no longer re-

[32] Daggett, *Railroad Reorganization,* p. 207.

[33] The statement of the reorganization committee, pointing out the necessity of the drastic sacrifices required of the second mortgage bondholders has been frequently quoted: "It was not thought that a greater assessment than $10 could be raised from the stock, and the remainder had to come from the junior bonds."

[34] Details of the two Atchison reorganization plans are given in Daggett, *Railroad Reorganization,* pp. 206, 211; in which references will be found to the original sources.

garded as a sufficient readjustment to render sound and stable a bankrupt and impoverished railroad system.

The reorganization of the Atchison Railway was among the first of the great railroad reorganizations following the panic of 1893. It was prophetic of the new spirit. Already in the Wabash reorganization, outlined above, the new order began to show itself. But in the contrast between the English bondholders' and the final plan of the Atchison, the contrast between the old and new orders stands clearly defined. It marks the transition, historically, from the third to the fourth period of reorganization policy, outlined in the earlier paragraphs of this article. And this means more than a mere academic distinction. For the line of demarcation between the great railway reorganizations prior to that of the Atchison in 1895 and those contemporary with it and following it is more distinct than that between any other of the historical periods.

From the first Erie reorganization down to the English bondholders' Atchison plan, a period of thirty years, there had been a growing realization that a railroad reorganization, to be permanently successful, must be drastic and comprehensive. But this realization was of slow growth.[35] Lawyers stuck to the legal phraseology of bonds and mortgages, insisting that the contractual rights of bondholders must be protected at all hazards, and investors were intolerant and obstructive if forced to submit to anything more than the most superficial and temporary sacrifices.

There were several significant motives to explain the comparative leniency with which bondholders were treated in the reorganizations prior to 1895. All men assumed that the railroad industry was inherently profitable, and would grow as the resources of the United States were developed. And this being the case, increasing prosperity might be expected to absorb any ordinary burden of fixed charges which might be placed on a railroad. In many cases it was presumed by over-confident reorganization managers that even an extraordinary burden could be carried,

[35] The view here taken, that bondholders were treated more leniently in the earlier reorganizations is different from the judgment of Meade, who has contended that the position of the bondholder has been stronger since 1893 than before (*Ann. Am. Acad.*, vol. XVII, p. 232). The view expressed here seems to be in agreement with Crowell (*Yale Review*, vol. 7, p. 319). It is also implied by the exhaustive statistics of Meany (*1900, Poor's Manual of Railroads*, pp. lxxxix and cvi) and specifically given by Daggett's statistics and suggested by his statements of comparison. (Daggett, *Railroad Reorganization*, pp. 358, 363.)

provided drastic competition could be, for the moment, alleviated. Again, the courts showed every inclination to protect the bondholder, should he object to any sacrifice of principal or interest that a stockholder management might wish to impose upon him. By resorting to a variety of legal steps, the bondholders could impede, perhaps frustrate, the reorganization. Further, by no means least important, there was the fact that a large proportion of the bonds of our American railroads were held in England and on the Continent.[36] These foreign bondholders acted as a unit against any effort to emasculate their position. They could not be prevailed upon to relinquish any of their literal rights so long as any equity remained to the American stockholders; and the American stockholders refused to relinquish their shadow of an equity because of their inherent confidence in the ultimate prosperity of the railroad industry.[37]

These few historical cases and the generalizations one may draw from them refer to a period of railway finance long since past. Beginning with the crisis of 1893 the motives outlined above that controlled the previous reorganization practice ceased to dominate reorganization managers. A new era of financial history dawned, and with it a new policy toward railroad reorganization. No longer were there any scruples shown in the treatment of the bondholder. Forced by the obvious plight in which the railroads of the country found themselves in the depression from 1893 to 1897, people generally recognized that only through the most drastic cutting of fixed charges, accompanied by large investments of new money, could the bankrupt and impoverished roads be rehabilitated. No longer did the reorganization plans show the dictation of English bondholders who, by delaying their consent, could impede the reorganization; no longer did the courts aid the

36 After a rapid survey of the railroad receiverships consequent on the panic of 1873, Crowell states: "One hundred and fifty millions, or 15 per cent of the American railway bonds in default at the end of this, the first great crisis in this class of securities, were held in foreign countries, largely in Germany, Holland and England. This was about 40 per cent of the entire amount of foreign holdings of American railway securities." Crowell, *Yale Review*, vol. 7, p. 324.

37 Crowell gives what might be considered another reason, namely, that "many of the mortgages could not be foreclosed at all, because the State had endorsed the bonds and had the right of foreclosure, which it did not exercise because it did not want the road or did not want to sacrifice the property by a forced sale in the midst of financial depression. The State could not be sued on its endorsement." (*Ibid.*, p. 326.)

"striking" bondholders. And, finally—perhaps more prophetic of the new period—men no longer assumed that the railroads would become prosperous, ultimately, no matter what burdens they were compelled to carry.

Many reasons explain the change of opinion. At every period of financial history, those reorganizations consummated at the time of a financial panic or business depression are more drastic than those consummated during a period of business prosperity. Then, too, the influence of the late J. P. Morgan was dominant and worked in every instance for the distribution of sacrifices and the casting of the financial pattern according to actual earnings. But most of all there was a common consciousness that the era of promotion was past and that the restitution of confidence in the industry required that the railroads be given a definite economic stability and their bonds made a secure investment. To accomplish this, sacrifices were required of all who took part in the period of promotion and extension, and permanent protection for those who, in the hour of need, showed their confidence by contributing new money. In attaining these ends the old bondholders were called upon to play their part. As a result of the drastic reorganizations of the period of the middle nineties, the railroads of the country emerged with new life, rehabilitated physically by investment of capital, and freed from overburdening debt.

As a result of the thoroughgoing and drastic reorganizations of the large railway systems, following the panic of 1893, principles of reorganization practice were thoroughly established which were applied with uniform precision to the recent railway failures—those occurring in the last period since the panic of 1907. Omitting, for the purpose of this introductory survey, confusing exceptions and unimportant details, one may summarize contemporary reorganization practice in the following general terms.

As far as the formal procedure is concerned, a reorganization brings about an adjustment—represented usually by a compromise—between the strict construction of the legal obligations of the various security owners and creditors of the road, and the necessity, from the public point of view, that the railroad maintain its service as a solvent, responsible and progressive corporation. It is the balance between private and public interests. While pretending to hold to the strict construction of the law, the courts have been inclined to allow all interests, no matter

what their equable rights might be, to participate in the reorganization provided an improved railroad service can be promised to the public. Neither state nor federal laws have much to do with determining the character of railroad reorganization, the courts allowing the parties most concerned to work out any plan that is expedient and approximately just, provided it is socially and economically sound. And the resulting compromise between the strict rights of the bondholders, the welfare of the public, and the blasted hopes of the stockholders, is based on expediency tempered by justice, rather than justice tempered by expediency. It is carried through under the sanction of a system of law which has grown up as a response to the peculiar economic conditions of a new country, a system of law which has sought to preserve the form of a legal practice existing long before railroads were conceived, while modifying its substance to meet the actual conditions of railroad success and failure in this country.

As far as the specific results are concerned, the present practice rests, as has been previously suggested, on the elemental principle that two primary ends must be achieved in every railroad reorganization. The more immediate, but less fundamental, is the creation of a fund of money, obtained primarily by a levy on the stockholders, out of which to pay the accumulated debt at the time of the receivership, the improvements of the road during the receivership, the expenses of reorganization, and finally to provide the means that shall keep the reorganized road from incurring new floating debt during the period of its rehabilitation. The second end is the reduction in fixed charges. The letter of the railroad mortgage bond has come to be nothing more than mere legal verbiage, but if the property covered by the mortgage has earned its charges the mortgage is allowed to remain and the bondholders are not asked to make sacrifices. If, on the other hand, the property behind the mortgage has failed to earn its charges, the bondholders are forced to accept a lessening, perhaps a total extinction, of their rights to demand a fixed income. They may object, but they are powerless to resist, except by acquiring the actual property itself at foreclosure sale, and the failure of their property to earn its charges prior to the receivership gives little promise that its earnings will be better after the bondholders themselves have exercised the letter of their legal rights and acquired the actual operation of the road alone. We have here another illustration of the fundamental truth that the economic

value of physical property is no greater than its inherent earning capacity.

The syndicate of bankers that is called into existence to finance the reorganization will probably dictate the plan.[38] Normally the plan will provide for the formation of a new corporation which shall take over the assets of the old one, subject to such underlying liens as are not affected by the reorganization. The syndicate is then in a position to issue entirely new securities which are superior to every liability of the old corporation except the undisturbed prior lien bonds. Such new securities are ordinarily of three classes. They may be designated as the fixed charge, the contingent charge, and the common stock securities. The first class will consist of a large issue of general mortgage bonds, having a small interest rate, the total aggregate of which is less than the net earnings of the railroad during the receivership. The second class will be income bonds or non-cumulative preferred stock—preferably the latter— the interest or dividend payments of which, together with the interest on the other bonds, will increase capital charges to the maximum income prior to the receivership. The third class will be the common stock, large in amount, but having no fixed or contingent charge, and distributed freely in order to placate the sacrifice of the old security holders.

The plan will propose as well to secure new money in order to pay the floating debt, the receivers' certificates, and to improve the physical property of the road. This new money will come from two independent sources. A syndicate will purchase of the new corporation a block of the new fixed-charge, general mortgage bonds, referred to earlier. The holders of the stock and possibly the junior bonds of the old corporation will be taxed or assessed as much as they can be induced to pay for the privilege of belonging to the new corporation. For this willingness to contribute money to the rehabilitation of the corporation, they will be given participation in the new road. This participation is usually represented by a combination of contingent charge securities and common stock. To assure the new road of the proceeds of the assessments, the syndicate which has undertaken to buy a

[38] The reader must remember that the next few paragraphs express merely general principles to which all railroad reorganizations more or less conform. The more recent the reorganization, the more nearly it conforms to this type. Nevertheless, exceptions to every one of the following principles abound. Details, variations, and exceptions, when significant, will be discussed in two succeeding articles.

part of the issue of general mortgage bonds will probably agree to pay the assessment demanded of any delinquent stockholder and assume his rights in the new corporation.

The same idea can be restated in the uses to which the three new classes of securities are put. The bonds involving fixed charges are taken in exchange for all or part of those of the old bonds which can justly claim that their interest has been earned and will be earned under all circumstances, and the rest are sold to the syndicate for money. The securities bearing contingent charges, together with the common stock, are given, in varying combinations, to the holders of those old bonds, the interest on which had not been fully earned, and to the stockholders, on condition of the payment of a certain tax or assessment. As a result of these transformations, the almost invariable consequence of every railroad reorganization since 1895 has been that the road emerges from its troubles with a lower fixed charge against income but with a higher total capitalization. The bonds and the fixed interest charges are reduced; but the par value of the preferred and common stocks increased, from the necessity of distributing these securities freely, in return for the sacrifices made by the old junior bondholders and stockholders. We are thus presented with the striking anomaly that the bankruptcy of a railroad corporation leads to a direct increase of its total issued securities. We are also presented with the even more striking anomaly that in the presence of financial failure and its consequences the public service character of a railway corporation is brought most clearly into evidence.

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